Using Low-Income Housing Tax Credits for Affordable Housing

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The Federal Tax Credit Program

- How do tax credits work?
- What do tax credits finance?
- What is the legal structure?
- How are project responsibilities shared?

How The Housing Tax Credit Program Works

- In Section 42 of the Internal Revenue Code
- States administer the Federal tax credit program
- Each State receives $1.80 per capita annually to allocate, adjusted for inflation
- A State housing finance agency is responsible
- Threshold eligibility criteria for household income levels always must be met—below 60% of AMI—area median income.

Why Do a LIHTC Project?

- Builds a community's affordable housing stock
- Each project uses a self-financing structure
- Sponsors earn various fees –
  - a developer's fee for each project
  - other project fees (property mgt, etc.)
- Sponsor shares in project's cash flow

How LIHTCs Work

- Provide a dollar-for-dollar credit against income tax liability of investors
- Generally, tax credits are taken over the initial 10-year operating period
- Investors also take any tax losses over the entire investment period
- The IRS recaptures some of the LIHTCs if the project fails during the first 15 years—this is the primary risk to the equity investors

Legal Structure

- Project owner must be a taxable entity
- Limited partnership owns the project
  - Passes tax benefits through to investors
- Ownership is split
  - Limited Partner share = 99.99%
  - General Partner share = 0.01%
- Project management
  - Property managed by a property manager
  - Remains in compliance for 30 years or more

Project Responsibilities – General Partner

- The Sponsor can be either a for-profit or a non-profit entity
- The Sponsor creates a General Partner that
  - Is typically a for-profit subsidiary of the sponsor
  - Owns only 0.01% of the L.P. but
  - Controls and operates the project
  - Handles all reporting and tax matters
  - Receives a share of the cash flow per terms of the partnership agreement

Project Responsibilities – Limited Partner

- The Limited Partner – typically a large corporation which invests through a syndicator such as NEF
  - Purchases an interest in the partnership
  - Invests equity for acquisition and construction
  - Owns 99.99% of the partnership
  - Receives almost all project tax credits and tax losses
  - Limits role to investing equity, getting tax benefits
  - Monitors the project’s operations
  - Has expanded rights if the project gets in trouble

Income and Rent Limitations

- Always present with any tax credit project
- Threshold election – rents must be affordable
- Maximum rents are set at 30% or less of AMI adjusted for the number of bedrooms
- Area Median Income (AMI) information is:
  - published annually by HUD
  - Available for each county or SMSA in the US
  - Always calculated for a family of four
- Actual household incomes are adjusted for family size

State Award Procedures

- Each State reflects its housing priorities in its Qualified Allocation Plan ("QAP")
- The QAP establishes the State's competitive procedure for allocating tax credits
- States often give competitive preference where
  - target income levels are below thresholds
  - projects serve priority tenant populations
  - projects use preferred financing structures

Structuring Concepts

- LIHTCs fund 1/3 to 2/3 of a project's costs
- LIHTC equity funds, on average, 50% of the total costs of the average NEF project
- Typically, debt funds the rest of project costs
- Hard ("must-pay") debt must be sized carefully for project viability
- Careful structuring is needed if HOME and certain other kinds of debt are used
- Grants usually run thru the sponsor, which can lend the grant proceeds to the partnership

What Gets Considered in Structuring a Deal?

- Quality of Your Development Team
- Characteristics of Your Project
- Your Sources of Financing
- Your Development Budget
- The Cash Flow the Project will Generate
- Project Reserves
- Guarantees of the Developer and Others

Who Are the Parties in a Syndication?

- **Development Team**
  - Developer
  - General contractor
  - Architect
  - Attorney
  - Property manager
  - Accountant
  - Consultants
- **State Allocating Agency**
  - Allocate tax credits
  - Provide soft loans
  - Monitor compliance
- **Lenders**
  - Construction lender
  - Permanent lenders
  - Lender attorneys
- **Syndicator**
  - Equity underwriter
  - Attorney
  - Project monitoring
- **Other Professionals**
  - Engineers, Historic, Environmental, etc.

Timeline - Tax Credit Project After Predevelopment Stage

- Apply for and receive a tax credit reservation—6 mos.
- Incur 10%+ of costs by later of
  - end of year 1 or
  - 6 mo. from reservation
- Carryover tax credits until project completion
- Complete project and place it in service—24 mos.
- Apply to State agency to start tax credits for all buildings
- Rent tax credit units to qualified tenants--36 mos.
- Keep tax credit units in compliance--initial 15 years (investor withdraws), then extended use period

Calculating Tax Credits

- **Tax credit rates**
  - The “9%” new construction/rehab rate
  - The “4%” rate (acquisition and federally subsidized debt)
- **Tax credit basis—cost of the project**
  - Eligible basis
  - Qualified basis
- **The tax credit calculation**
- **The “Equity Raise”**

Types of Tax Credit Rates

- **9% New Construction/Rehab Credit Rate**
  - the standard kind of tax credit
- **4% New Construction/Rehab Credit Rate**
  - used when there is federally-subsidized financing (tax-exempt bonds, USDA-RD)
- **4% Acquisition Credit Rate**
  - used when you purchase an existing building that qualifies

Determine Tax Credit Basis

- **Total Project Costs**
  - Includes all project costs less
    - All costs not related to residential rental housing
    - Or not able to be depreciated
- **Eligible Basis**
  - Depreciable basis of residential rental housing (what's eligible for tax credits) less
    - Costs related to units occupied by non-eligible tenants, often will be market rate units with no income restrictions
- **Qualified Basis**
  - Includes Eligible Basis costs of only the units occupied by qualified tenants

Adjustments to Eligible Basis

- **Eligible Basis**
  - Residential Rental Housing
- **Adjusted for**
  - "Applicable Fraction"
    - the lesser of % of units or square feet qualifying for credits
  - Basis Boost
    - increase tax credit basis by 30% if the building is in a Qualified Census Tract ("QCT") or a Difficult to Develop Area ("DDA")
- **Qualified Basis**
  - Includes Eligible Basis costs of only the units occupied by qualified tenants

Qualified Tax Credit Basis Equals Total Project Costs Minus:

- land & land-related costs
- non-residential costs
- non-low income part of the project
- fees and costs related to permanent loan financing
- post-construction working capital
- project reserves
- federal grants
- syndication-related costs
- building acquisition and related costs
- historic tax credits taken on the project

Steps to Finance Your Project:

- Step 1: Estimate development budget and derive qualified basis
- Step 2: Estimate tax credits generated with published tax credit rate
- Step 3: Estimate tax credit equity—must estimate current market price of the equity
- Step 4: Estimate cash flow available for debt
- Step 5: Size the amortizing mortgages
  - 1st mortgage amount—debt coverage ratio is key factor
  - 2nd mortgage amount—rare
- Step 6: Calculate the gap in funding
- Step 7: Fill the gap with other funds

Compute Annual Tax Credits

	No Boost	Basis Boost
▪ Total Project Costs	$5,000,000	$5,000,000
▪ Less Non-Deprec. Costs	$1,000,000	$1,000,000
▪ Eligible Basis	$4,000,000	$4,000,000
x Applicable Fraction	100%	100%
x QCT/DDA Basis Boost	100%	130%
▪ Qualified Basis =	$4,000,000	$5,200,000
▪ x 9% Tax Credit Rate =	7.91%	7.91%
▪ Annual Tax Credits =	$ 316,400	$ 411,320

Compute Total Tax Credits and the Equity Raise

	No Boost	Basis Boost
▪ Annual Tax Credits	$ 316,400	$ 411,320
x 10 Years		
▪ Total Tax Credits	$3,164,000	$4,113,200
x Price Paid ("Equity Raise")	$0.90	
▪ = Tax Credit Equity	$2,847,600	$3,701,880
▪ Value of Basis Boost	$ 854,280	
▪ % of Costs from Equity	57%	74%

Sizing the Debt (1)

- Assume Cost $5.0 million; Equity = $2,847,600
- Gross Rental Income $350,000
- Less: vacancy (7%) $ 17,500
- Net Rental Income $332,500
- Less: Operating Expenses $150,000
- Less: Cap. Reserves $ 25,000
- Net Operating Income
  Available for Debt Service $157,500

Sizing the Debt (2)

	Total
■ NOI for Debt Service	$ 157,500
■ Debt coverage ratio – NOI /1.15	
■ Available for debt service	$ 136,957
■ First Mortgage Terms	
7.0%, fully amortizing 30 years	
■ Mortgage amount	$1,715,479
■ Tax credit equity	$2,847,600
■ Funding gap (need other sources)	$ 436,921

Sources of Funding to Fill the Gap

- Federal HOME, CDBG funds
- Federal Home Loan Bank (AHP funds)
- State loan programs
- Deferral of part of developer's fee
- Cost savings (development or acquisition)
- Modification of 1st, 2nd mortgage terms
- Increase rents or decrease expenses—allows increase in debt if supportable

Underwriting Standards That You Should Know

- Market
- Projections
- Sponsor
- Development Team

Market

- Capture Rates
  - Less than 12%
- Discount to Market
  - Minimum of 5% below competing conventional and tax credit projects
- Discount to Maximum Tax Credit Rents
  - Minimum 5%
- Location Characteristics
- Sec. 8 Voucher Limits

Projections

- Operating Expenses
  - Typically not less than $3,500 per unit
  - Never below $2,000 per unit after taxes and utilities
- Vacancy Rates
  - Less than 20 units = 10%
  - Greater than 20 units =7%
- Trending
  - 2% for income
  - 3% for operating expenses and replacement reserves
  - 1% spread minimum

Projections Cont.

- Debt Service Coverage Ratio
  - Not less than 1.15
- Contingency
  - New Construction = 5%
  - Rehab = 8-10%
- Commercial Income
  - Cannot be used for underwriting debt

Projections Cont.

- Operating Reserves
  - Minimum of six months of operating expenses, debt service and replacement reserves
- Replacement Reserves
  - New Construction = $250 per unit per year
  - Rehab = $300 per unit per year
- Section 8 Projects
  - Sensitivity analysis for contracts that are subject to appropriations and additional reserves are necessary.

    Note: Rehab projects will require and Capital Needs Assessment, Replacement Reserve study and prior years audits.
- Adequate Construction Budget

Sponsor Capacity

- Financials
  - Three years financial statements plus year to date
  - Audits for not-for-profit organizations
  - Tax Returns
- Background Searches
  - Credit Reports and Lien/Litigation searches
- Previous Experience
  - Statement of Activity
  - Track Record
  - Condition of existing portfolio
- Adequate and Experienced Staff

Development Team

- Architect
  - Experience/Track Record
  - Supervision during construction
  - Quality and appeal of design
- General Contractor
  - Bonding Capacity
  - Experience/Track Record
  - On-time/On-Budget
- Property Management Agent
  - Experience with Tax Credits
  - Compliance experience
  - Approval of operating budget
  - Adequate staffing
- Project Accountant
  - Experience
- Project Attorney
  - Experience

How to Contact Us

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